

Economic Survey of Brazil, 2009

How is Brazil coping with the global financial and economic crisis?

How can Brazil's long-term growth prospects be improved?

What needs to be done to strengthen macroeconomic policies further?

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Summary

The global financial and economic crisis has not left Brazil unscathed. But a recovery is getting under way and should gather momentum in the second half of 2009 and into 2010. Continued macroeconomic consolidation – based on a sound policy framework combining inflation targeting, a flexible exchange rate and rules-based fiscal management – together with a much improved external liability position have underpinned the economy's resilience. Policymakers should nevertheless not lose sight of longer-term challenges that will need to continue to be addressed to bolster the economy's growth potential and to close the gap in living standards in relation to the OECD area at a faster pace.

Reaping the benefits of macroeconomic consolidation

The short-term policy response to the global financial and economic crisis has been by and large appropriate. Decisive action to shore up liquidity since the onset of the crisis has been important, and there may be room for some further monetary easing in the coming months. Fiscal policy has been relaxed on cyclical and discretionary grounds without compromising longer-term debt sustainability, but additional activism would be inadvisable, unless activity weakens much further. Additional structural reform should focus on containment of expenditure growth in support of continued fiscal adjustment, as well as on further financial deepening, based on a gradual elimination of compulsory reserve requirements for banks and a phasing-out of existing directed credit operations.

Reforming indirect taxes and labour levies

Brazil's tax system is complex, conducive to predatory tax competition among the states and burdensome on labour. Overcoming these weaknesses is of utmost importance. The authorities propose to unify state-level VAT legislation across the country, to replace federal levies on enterprise turnover and payroll by a federal VAT and to alleviate the tax burden on labour income. A well thought-out reform package is under discussion in Congress. Support will be needed, especially among the state governments, to ensure that reform is efficiency-enhancing and consistent with ongoing fiscal adjustment efforts.

This Policy Brief presents the assessment and recommendations of the 2009 Economic Survey of Brazil. A draft of this Survey was prepared by the Economics Department and discussed at a meeting of the Economic Development and Review Committee, which is made up of the 30 member countries and the European Commission, on 4 June 2009. The Survey is published under the responsibility of the Secretary-General of the OECD.

Making government operations more cost-effective

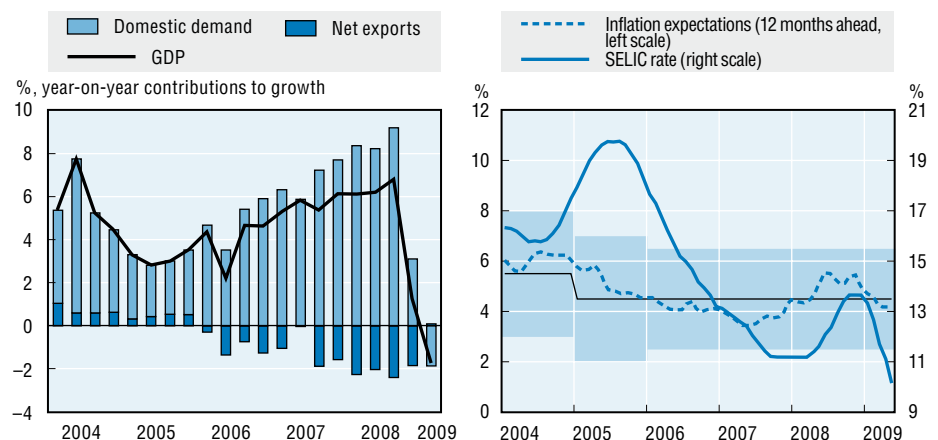
Brazil is a big spender by emerging-market standards and, in some respects, in comparison with OECD countries. But outcomes are not always commensurate with the level of spending, suggesting ample scope for efficiency gains in government operations. The payoff from initiatives to strengthen longer-term planning and to reduce downward rigidities in the budget would be large. Progress in this area would allow policymakers to identify cost-effective programmes more accurately and to secure adequate funding for these programmes, including through a reallocation of budgetary resources. ■

How is Brazil coping with the global financial and economic crisis?

Domestic financial conditions tightened considerably as the global financial and economic outlook deteriorated from mid-September 2008. The supply of foreign credit to Brazilian enterprises, including exporters, had been abundant before the crisis but dried up rapidly. The cost of domestic borrowing rose sharply, and the *real* depreciated by over 40% from the highs of mid-2008 through year-end. Activity plummeted in the last quarter, dragged down by a collapse in industrial production, especially in credit-sensitive sectors, such as the motor industry, and a run-down in inventories, albeit from high levels. Demand for Brazilian exports also began to weaken later in the year. However, pressures were notably lower than those experienced by other large emerging-market economies. This is due essentially to the continued consolidation of macroeconomic adjustment following the floating of the *real* in 1999 – based on a policy framework combining inflation targeting, a floating exchange rate, rules-based fiscal policymaking and prudent public-debt management. This policy framework has delivered gradually falling inflation and public indebtedness, and has reduced external vulnerabilities. These factors have been essential for increasing resilience to external shocks and have laid the groundwork for raising the economy’s growth potential. Another reason for relatively good performance in spite of the crisis is that the banking sector is in good shape, and the non-financial corporate and household sectors do not suffer from the balance-sheet weaknesses that are at the heart of financial distress elsewhere. Indeed, there are signs that the economy is recovering, although the global economic outlook remains extremely uncertain.

The central bank took decisive action to enhance liquidity in the domestic money market by reducing compulsory reserve requirements for banks, which have traditionally been tight, by some 3.5% of GDP during September-December 2008. The authorities also created incentives for larger financial institutions to purchase the loan portfolios of smaller banks, which were affected particularly adversely by the deteriorating credit environment. As in previous periods of financial distress, interventions in foreign-exchange markets were carried out in a transparent manner; they were aimed at ensuring liquidity in periods of thin trade and geared towards smoothing excessive volatility in the exchange rate. The relaxation of the monetary stance

Figure 1.
TRENDS IN GDP GROWTH AND MONETARY POLICY, 2004-2009



Source: IBGE and Central Bank of Brazil.

as from January 2009 has been appropriate; it has brought real *ex ante* interest rates to historically low levels. *There may well be room for some further monetary easing in the near term, depending on the strength of the recovery and the evolution of inflation expectations over the coming months.*

Fiscal policy responses to the crisis have included an alleviation of the tax burden on selected sectors, including the motor vehicle and construction industries, and on financial transactions. Cyclical revenue losses associated with the automatic fiscal stabilisers will also add to fiscal support, together with an increase in the duration of unemployment insurance and higher spending related to hikes in the minimum wage and in social protection, infrastructure development and social housing programmes. The consolidated primary surplus is projected by the OECD to fall from 4.6% of GDP in 2008 (before a transfer of 0.5% of GDP to a newly created Sovereign Wealth Fund) to 2.3% of GDP in 2009, which is close to the official target of 2.5% of GDP. A federal loan to BNDES, the National Development Bank, as well as other government-owned banks, of up to 4% of GDP during 2009-10 is allowing these institutions to expand their lending. *Moving forward, the authorities are advised to let the automatic stabilisers work unimpeded, rather than engaging in further discretionary activism, unless the slowdown in activity turns out to be more severe than expected.* A supplementary rise in the budget deficit needed to finance additional discretionary measures would put pressure on financial markets and therefore crowd out the private sector in a particularly challenging credit environment. In addition, counter-cyclical fiscal action that would result in an increase in expenditure commitments on a permanent basis would be inconsistent with efforts to prevent a further ratcheting-up of current expenditure. The pace of monetary easing would also certainly be constrained if confidence in the fiscal programme is eroded. ■

How can Brazil's long-term growth prospects be improved?

Annual GDP growth rose to 4.7% on average during 2004-08, more than double the outturn of the previous five years that had followed the floating of the *real*. The fact that faster growth is delivering tangible improvements in the distribution of income, which nevertheless remains notoriously skewed in Brazil, is particularly auspicious. But, for the strong performance of the last few years to be maintained, there is no room for complacency. *Policy effort will need to be focused on building on past achievements and on making headway into policy areas where progress has been less comprehensive than desired.* This is the case for reform of Brazil's indirect taxes and labour levies, as well as initiatives to enhance the efficiency of government operations, discussed in detail in this *Survey*. New policy challenges have also arisen, including those related to the regulatory framework for developing the recently discovered offshore oil and gas fields and to the use of the associated revenues accruing to the budget. They will need to be confronted in the near term to make sure that Brazil makes the best possible use of these natural resources so as to generate dividends for future generations. ■

What needs to be done to strengthen macroeconomic policies further?

Brazil's fiscal track record, as gauged in terms of attainment of the primary budget surplus targets, is exemplary. This, together with prudence in public debt management, is delivering a gradual reduction in public indebtedness. In addition, the government now enjoys a net foreign asset position; as a result, unlike in previous episodes of financial duress, its debt dynamics are no longer affected adversely by a depreciation of the exchange rate. These

are remarkable achievements, especially because public indebtedness has traditionally been the single most important source of macroeconomic vulnerability. The government has been able to sustain fiscal adjustment, despite the limited room for manoeuvre caused by a ratcheting-up of current spending over the years and strong downward rigidities in the budget, through revenue hikes. To illustrate, primary general government spending has risen by almost 7% of GDP since macroeconomic stabilisation in 1994 to nearly 32.5% of GDP in 2008. Measures will therefore need to be taken to stem further increases in expenditure in the future. *To do so, a cap could be introduced on the expansion of outlays.* Attempts to introduce such a ceiling have been made in the past, and draft legislation to that effect awaits Congressional approval. Policy action in this area is important to make room in the budget for rebalancing expenditure in favour of capital outlays, which would be consistent with the authorities' efforts to develop infrastructure and to reallocate budgetary appropriations towards cost-effective programmes.

Much has been done over the years to put the pension system on a sounder financial footing. Parametric reforms included a comprehensive overhaul of pension entitlements for private-sector workers in 1998 to discourage early retirement and to encourage the creation of complementary retirement savings schemes. The separate social security regime for civil servants was reformed in 2003, although several provisions are yet to be legislated, including the creation of complementary pension funds for government employees. More recently, initiatives have been taken to improve compliance in the regime for private-sector workers through better enforcement and administration, including the transfer of responsibility for collection of social security contributions from the Ministry of Social Security to the Federal Revenue Service. Backtracking on these policy efforts would be regrettable. Robust economic growth in the last few years, which has delivered rising incomes and plentiful job creation in the formal sector, has contributed to stabilising the deficit of the social security system. But its long-term financial sustainability could be bolstered through complementary measures. This is important, because pensions for private-sector workers account for about one-third of federal primary expenditure, and outlays on pensions for retired civil servants are placing an increasingly heavy financial burden on the states and municipalities. Consistent with previous OECD policy advice, *minimum age provisions should be introduced in the private-sector regime for retirement on the basis of length of contribution; the link between pension benefits and the minimum wage should be severed, although the purchasing power of the minimum pension could be at least maintained, possibly through its indexation to a price index that best reflects the consumption basket of pensioners; and regulations should be issued allowing for the creation of complementary pension funds for civil servants, preferably of the defined-contribution type and in line with entitlements prevailing in the private sector.*

The public debt-to-GDP ratio is likely to remain at close to 40% of GDP in 2009-10 and then to fall gradually to close to 35% over the medium term. This achievement is commendable but does not obviate the need for continued prudence in financial management and unabated commitment to the consolidation of fiscal adjustment. This is because Brazil's gross public debt remains high by comparison with its emerging-market peers, and a rapid fall in the net debt-to-GDP ratio late in 2008 was due predominantly to a pronounced exchange-rate depreciation, rather than to enhanced fiscal effort, given that the public sector is now a net foreign creditor. *Future policy*

discussions should focus on setting the level of public indebtedness that the authorities consider appropriate for the longer term and the corresponding budget targets. The policy debate on this matter should be guided by the need to prepare for the emergence of future liabilities, including those associated with the pension system. To do so, Brazil already has the budgetary instruments required for longer-term planning and policy evaluation, such as the Budget Guidelines Law (LDO) and the multi-year budget plan (PPA). One important consideration is the use of budgetary savings associated with a likely fall in debt-service obligations over the coming years. A case can be made for using these savings to retire debt at a faster pace, to alleviate the tax burden while tackling the well-known weaknesses of Brazil's tax system (discussed below) and to reallocate at least part of the budgetary appropriations towards cost-effective programmes, which would be consistent with ongoing efforts to improve the efficiency of government operations.

The authorities have expressed their intention to redefine the fiscal rule in terms of the overall (nominal) budget balance, rather than the primary budget surplus. *This would be a positive development.* It makes sense to focus on the primary budget surplus when debt maturities are short and the bulk of the traded public debt pays floating interest rates or is indexed to the exchange rate. In such an environment, interest payments are overly sensitive to short-term fluctuations in the exchange rate and to changes in the monetary stance. But this situation is now changing: sustained fiscal adjustment and prudent public debt management have raised the average duration of traded securities and reduced considerably the shares of floating-rate debt and of instruments indexed to the exchange rate or denominated in foreign currency in the stock of government financial liabilities. In this new policy environment, a focus on the overall budget balance, rather than on a fiscal aggregate that excludes interest payments, would be welcome, because the consolidated public sector's overall budget balance has remained in deficit, despite earlier successive increases in the primary surplus target and continued adherence to the fiscal rule. If the fiscal rule is redefined, it would be advisable to draw increasing attention to trends in the overall budget balance in public communications in preparation for its future adoption as the fiscal target. This would ensure a smooth transition to the new, more appropriate fiscal rule and contribute to building confidence in the policy framework.

Brazil's monetary policy framework changed radically ten years ago, when the *real* was allowed to float freely. The current regime, combining inflation targeting and a flexible exchange rate, is working well, as noted in previous *Surveys*. Monetary policy has been conducted in a forward-looking manner, and the central bank's inflation-fighting credentials have been strengthened over the years. The policy move in late 2008 to free up part of commercial banks' required reserves held at the central bank was essential for shoring up credit as the global financial and economic crisis worsened. Nevertheless, *there is still considerable scope for easing the remaining compulsory reserve requirements for a variety of bank deposits.* Progress should be sought in this area, because it would reduce the implicit tax burden on financial income, which would lower intermediation costs. Most countries that have adopted inflation targeting as the framework for monetary policymaking have reduced or eliminated such requirements.

Another consideration is the existing regulations on the allocation of credit to selected sectors, especially agriculture and housing, including through mandated saving arrangements. These requirements were introduced in the past, when financial markets were less developed, and market failures would have prevented sufficient credit from being extended to important sectors of economic activity. But maintenance of mandated credit provisions may well be impeding further financial deepening and resulting in resource misallocation. *These restrictions should be gradually removed to improve the efficiency of the financial sector and to reward long-term saving adequately.* As in the case of compulsory bank reserves, these constraints on the allocation of credit amount to a tax on financial income, which affects the cost of intermediation. The payoff from reform in this area could therefore be considerable in terms of reducing the stubbornly high real rates of interest facing those without access to preferential credit terms, which weigh heavily on the economy's growth potential. ■

Are there options for making the indirect tax system more efficient?

The authorities are taking welcome steps to correct important deficiencies in the tax system. Considerable gains can be achieved through policy action in this area in terms of increased welfare and faster economic growth. Draft legislation was submitted to Congress in February 2008 to reform the state-level value-added tax and alleviate the tax burden on enterprise turnover and labour income. Brazil's indirect tax system is particularly cumbersome to enterprises, due to its fragmentation, complexity and changing provisions. The tax burden on labour income is also heavy, owing to a combination of onerous social security contributions and a multitude of additional levies on enterprise payroll. The reform package, which is well thought-out overall, recognises the need for a careful setting of the new tax rates, because it encompasses the bulk of federal and state-level indirect levies. Revenue losses, which Brazil can ill afford in a period of consolidation of fiscal adjustment and until upward pressures on spending are mitigated, need to be avoided in the course of the reform. But, at close to 36% of GDP in 2008 according to OECD estimates, the country's tax take is high in relation to emerging-market comparators, which makes further hikes inadvisable. The introduction of a trigger mechanism requiring a re-calibration of tax rates if collections rise by a specified amount in real terms is therefore welcome. In any case, *the proposal to implement the reform only gradually is sound, as it would allow adjustments to be made, if needed, in terms of rate setting and tax administration.*

The proposed reform of the state-level value-added tax – the ICMS – focuses on reducing the scope for predatory tax competition among the states. In the current regime, the states are free to set ICMS legislation on intra-state transactions; therefore, they have often used the ICMS as an industrial policy instrument by granting tax breaks for investment. Several tax incentives have been ruled illegal by the judiciary, because they have not been sanctioned by an interstate council that has the prerogative to endorse state-level initiatives in this area (CONFAZ). The government proposes to tackle this problem by making rates and bases homogeneous throughout the country and by imposing heavier sanctions for non-compliance. The reform proposal also honours the incentives granted before 5 July 2008 and allows for arrangements put in place after that date and until the tax reform is approved by Congress to be maintained, if they are endorsed by the states. *While maintenance of the*

incentives granted prior to July 2008 is understandable on contractual grounds, those granted during Congressional deliberations on the reform should be annulled.

Another consideration is that the ICMS is collected at origin, although special provisions are in place for taxing interstate trade at a lower rate. As a result, exporting states are reluctant to refund credits earned in other jurisdictions. An accumulation of unrefunded credits creates an anti-export bias in the tax system, an issue that remains by and large unresolved. The authorities propose to deal with this problem by gradually shifting most collection to destination and by shortening the time frame for refunding value-added tax credits. Both initiatives are welcome. Nevertheless, *it would be desirable to shift all collection to destination, so that no ICMS-liable goods and services would be taxed at origin.* This would further simplify the tax system.

This shift to collection at destination would result in a significant reallocation of the tax take among the states. The government's reform proposal addresses this issue by strengthening its regional development policies, including through the establishment of a regional development fund (FNDR). Efforts in this area are welcome, because existing mechanisms for financing regional development focus on the poorer states and therefore fail to address the needs of the poorer areas of the more prosperous parts of the countries. *The regional development fund will need to be designed to encourage contestability in the use of development assistance.* In addition, the less developed states, which are net importers of ICMS-liable goods, are likely to be the main beneficiaries of the shift in collection location, but they are also likely to face capacity constraints on administering the new ICMS. As a result, *there is a role for the federal government in providing technical assistance to the states with weak administrative capacity.* ■

Can the tax burden on labour income be alleviated?

Previous reform initiatives have reduced the tax burden on enterprise turnover. This is the case of the conversion of federal levies (PIS and Cofins) into value-added taxes during 2003-04, although enterprises operating in several sectors, such as services and public utilities, as well as those that pay their taxes under presumptive regimes (*e.g.*, SIMPLES) continue to do so on the basis of turnover, rather than value added. The cascading nature of turnover taxation is particularly detrimental to the competitiveness of Brazilian exports. The government's current proposal seeks to take reform efforts a step further by reducing the tax burden on labour income through the elimination of *Salário-Educação*, a federal levy on enterprise payroll, and a reduction in employers' social security contributions. Developments in this area are particularly welcome, because, as argued in previous Surveys, a high tax burden on labour income encourages informality, especially among low-income workers. But there remain a number of para-fiscal levies on labour income, including the "S" system contributions (to finance sectoral development and labour training programmes) and contributions to INCRA (an agricultural development programme), which cost employers nearly 3.5% of payroll. *These contributions could be eliminated over time or, as argued in previous Surveys in the case of the "S" system, they could be converted into user fees, so as to allow for a better match between the services currently provided by the affiliated institutions and market demands.* With regard to employers' social security contributions, the option of reducing these contributions on low-paid workers could also be considered. Of course, the cost of foregoing much needed revenue at a time of

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consolidation of fiscal adjustment needs to be weighed against the impact on collections of increased formality in labour relations. ■

The level of public spending is particularly high in relation to GDP for a country of Brazil's income level and in comparison with its emerging-market peers. Government outlays on education and health care alone account for nearly 9% of GDP, the second largest item of spending following social protection. But outcome indicators are not always commensurate with the country's high level of government-financed spending, suggesting that service delivery is inefficient, rather than under-funded. Much has been done in education to raise enrolment rates, especially for secondary education, to equalise spending capacity among the sub-national jurisdictions, which account for the bulk of spending on education, and to introduce systematic performance assessments for students and institutions. These initiatives have been highly successful, particularly in terms of delivering near-full enrolment at the primary and lower-secondary levels. But the performance of Brazilian students remains comparatively low when judged on the basis of standardised international tests, such as PISA. Of course, it takes time for innovative policy initiatives to deliver sustained improvements in performance, and follow-through is essential. *Policy action should therefore focus on improving the quality of services for those levels of education where full – or nearly full – coverage has already been assured.* As argued in previous Surveys, the largest payoff from growth-enhancing reforms is likely to come from further improvements in human capital, with special emphasis on basic skills.

In health care, a number of conventional output indicators are not out of step with OECD averages. Following the decentralisation of service delivery in the early 1990s, increasing emphasis has appropriately been placed on enhancing preventive care. But, in a decentralised setting, cost-effectiveness depends a great deal on the ability of service deliverers to exploit economies of scale and scope. Experience with inter-municipal initiatives for procurement, as well as flexible arrangements for hospital administration and human-resource management, is by and large positive. *These initiatives could be disseminated more broadly among the sub-national levels of governments.* The identification of successful initiatives would be an important step towards setting best practices to be followed by policymakers.

As in other federal countries, mechanisms for financing decentralised provision often rely on inter-governmental transfers. The bulk of federal transfers to the states and municipalities are in the form of block grants related to the sharing of revenue collected by the federal government. Sub-national governments have full autonomy to use these resources, a prerogative that is awarded to them by the Constitution. Voluntary grants, which may be conditional, account for a small share of inter-governmental transfers. On the face of it, there appears to be limited scope for building incentives for cost-effectiveness into the transfer system. But a number of initiatives stand out in this area. The case of education is particularly instructive, in that the introduction of conditional and equalisation transfers for service delivery (under FUNDEF and subsequently FUNDEB) has been essential for financing the expansion of the municipal school network, especially in remote parts of the country. The success of these initiatives suggests that *the federal government could strengthen incentives for efficiency enhancement by making more extensive use of conditionality in voluntary transfers*

and by introducing rewards for performance. Initiatives to this effect would go in the direction of using the intergovernmental transfer system as a vehicle for efficiency enhancement without infringing on sub-national autonomy in policymaking and the use of sharable funds.

Brazil's budget institutions have been strengthened since the mid-1990s as an integral part of structural reforms in the macroeconomic area. Years of chronic inflation until then had favoured short-term financial management to the detriment of long-term planning and performance orientation in budgeting. A number of budget instruments are now available, including a four-year budget envelope (PPA), which lays out the government's longer-term policy priorities, and a three-year budget guidelines law (LDO), which sets fiscal targets for the annual budget laws. This institutional setting is appropriate for Brazil's policymaking needs, and experience to date is by and large positive, although there is room for further improvement. An important policy consideration is that, while the policy objectives stated in the annual budget laws should be consistent with, and in support of, longer-term goals set out in the PPA and the medium-term fiscal targets enshrined in the LDO, this nesting order is often reversed. As a result, especially in periods of fiscal stress, short-term policy considerations have often taken precedence over longer-term policy directives. To remedy this situation, *more effort is needed to improve the integration and consistency of the policy priorities set in the PPA and the targets included in the LDO and in the annual budget law.* Progress in this area is an important pre-condition for the regular evaluation of policy outcomes and for using the existing budget's institutional setting as a vehicle for cost-effective fiscal management.

Effort to enhance the efficiency of government operations will not come to fruition unless budgetary appropriations can be re-allocated towards the most cost-effective programmes. Nevertheless, as noted in previous Surveys, the flexibility required for performance-oriented budgeting is constrained by a number of institutional rigidities. For example, considerable revenue is earmarked, including that of the federal levies (*contribuições*) introduced over time to finance a variety of social programmes (discussed above). Including the compulsory sharing of federal revenue with the sub-national governments, almost 90% of federal revenue is estimated to be earmarked. Mandated aggregate spending floors, including for health care and education, have also been introduced over the years to ensure financing for a variety of programmes, regardless of their cost-effectiveness. *Policy action to make budgeting more flexible should focus on a gradual elimination of revenue earmarking and aggregate spending floors.* This would allow budget-making and planning to be guided more by efficiency considerations and the government's policy priorities, rather than historical costing and short-term revenue trends. Greater budgetary flexibility could also underscore efforts to contain the rise in current spending by making it easier to discontinue programmes that are not deemed cost-effective but whose financing is assured by spending covenants.

According to Brazilian legislation, budgetary appropriations can be discretionary, such as those for capital outlays, or non-discretionary, which includes pensions and payroll. In addition, the appropriations for discretionary programmes are authoritative, in the sense that the executive branch of government has the prerogative to establish ceilings for their execution that may be lower than those approved by Congress. This prerogative is often

exercised, because the legislature has the right to alter the budgetary envelope submitted by the government in the draft budget law; revenue is adjusted upwards on the basis of optimistic assumptions to accommodate higher discretionary spending. Nevertheless, this sequestration of appropriations for discretionary programmes complicates expenditure management and budget planning, especially for capital outlays. It also creates incentives for expenditure rigidities through the introduction of mechanisms to protect priority programmes from sequestration. *The option of making budgetary appropriations for discretionary programmes mandatory could therefore be considered in the longer term, but not until existing rigidities, such as mandated aggregate spending floors and revenue earmarking provisions, have been eliminated. A more cooperative arrangement would also need to be put in place between the executive branch and the legislature to ensure realism in revenue and expenditure projections, both in the draft budget law and in the budget approved by Congress.*

The discovery of large oil and gas fields in deep waters off Brazil's south-eastern coast may well double the country's proven reserves of about 14 billion barrels, although official estimates are not yet available. According to the International Energy Agency, Brazil accounts for about 40% of known undeveloped offshore reserves outside the OPEC area. Options are being considered for developing these fields. The current exploratory regime is based on concessions and the transfer of property rights over the hydrocarbon reserves to the concessionaires. The authorities are considering the introduction of production-sharing arrangements to develop the new fields, because their production costs are high and exploration risk relatively low, while maintaining the concessionary regime for the blocks that have already been auctioned. *Definition of the regulatory framework for the new fields is important to ensure that their development is not delayed by regulatory uncertainty.* Of particular importance is the need to set a clear role for the sector regulator in the new legal framework.

An arrangement will need to be made for sharing the revenue arising from the exploitation of the new offshore reserves of oil and gas among the different levels of government. Currently, the bulk of revenue from royalties and other levies accrues to the coastal municipalities and states that have proprietary rights over the offshore fields. Only a limited portion of revenue is shared with non-producing jurisdictions. Maintenance of the current regime would likely exacerbate this concentration of revenue in a handful of municipalities. In addition, the recipient localities tend to use the hydrocarbon revenue predominantly to finance operating expenditure with little long-run return. *It would therefore be advisable to introduce a new mechanism for sharing the revenue associated with the new oil fields among the different layers of government to ensure that it is saved and/or spent on programmes that could generate returns for future generations.* The recently created Sovereign Wealth Fund could be used to save the revenue that accrues to the federal government and/or to smooth transitory fluctuations in the budget associated with business and oil-price cycles. ■

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